ANALYSIS OF AMENDED BILL

Franchise Tax Board

Author:	Papan	Analyst:	Roger Lackey	Bill Number:	AB 984
Related Bills:	None	Telephone:	845-3627	Amended Date:	08/21/2001
		Attorney:	Patrick Kusiak	Sponsor:	California Trans Assoc.

SUBJECT: LAO In Consultation With BOE & FTB Study Sales & Use Tax Exemption For Use Of Sale & Leaseback Financing

SUMMARY

This bill would require the Legislative Analyst (LA), in consultation with Franchise Tax Board (FTB) and State Board of Equalization (BOE), to do a study related to the sales and use tax exemption of gross receipts on the purchase or lease of certain public transportation vehicles and vessels.

This bill also makes changes to the sales and use tax laws. This analysis will only discuss the bill to the extent it impacts the department.

SUMMARY OF AMENDMENTS

The August 21, 2001, amendments would add the study discussed in this analysis.

This is the department's first analysis of the bill.

PURPOSE OF THE BILL

The author's purpose for this bill is to assist public transportation in the purchase and lease of mass transit vehicles and vessels such as buses, ferry boats, locomotives, and related equipment.

EFFECTIVE/OPERATIVE DATE

This bill would be effective January 1, 2002.

POSITION

Pending.

ANALYSIS

<u>FEDERAL/STATE LAW</u>

Current state and federal laws generally allow taxpayers engaged in a trade or business to deduct all expenses that are considered ordinary and necessary in conducting that trade or business, including expenses associated with the leasing of vehicles.

Board Position:			Department Director	Date
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However, Internal Revenue Service Revenue Ruling 99-14, I.R.B. 1999-13, 3, (March 11, 1999), 1999-1 CB 835, which is applicable for California income tax purposes, provides that a taxpayer may not deduct rent or interest expenses associated with a lease-in/lease-out transaction if that transaction lacks economic substance other than tax benefits. A lease-in/lease-out transaction occurs when an entity leases an item to another entity that leases that item back to that entity.

Currently, state law allows the Department of Transportation (DOT) to purchase, sell, or lease mass transit vehicles by negotiation without competitive bidding to give the purchaser the advantage of the accelerated cost recovery method of depreciation provided by federal law. In addition, the transactions between DOT and the purchaser in these instances are not considered a sale or purchase for purposes of the sales and use tax laws.

THIS BILL

This bill would exempt the sale and lease of certain public transportation vehicles and related equipment from sales and use tax. This bill would require the LA to conduct a study on impact of the exemption. The study would include the:

- Number of persons using the exemption.
- Fiscal impact (including total exempted amounts and any depreciation claimed on the public transportation vehicles).
- The impact of federal law, including a federal tax ruling regarding lease-in/lease-out transactions, on the use of the exemption.
- The impact of the exemption on California's public transit sector.

The LA with guidance from FTB and BOE would conduct the study and prepare the report.

The study and its findings would be reported to the Legislature on or before January 1, 2003.

IMPLEMENTATION CONSIDERATIONS

Implementing the bill would not significantly impact the department's programs and operations.

OTHER STATES' INFORMATION

The sales and use tax laws of *Florida, Illinois, Massachusetts, Michigan*, and *New York* exempt governmental transactions from the sales and use taxes. While *Massachusetts* and *New York* specifically mention the exemption of public transportation vehicles, *Florida, Illinois, Massachusetts*, and *Michigan* provide a general statement excluding all governmental transactions.

The above states' sales and use tax laws were reviewed due to their similarities to California's sales and use tax laws.

FISCAL IMPACT

The extent to which the department would consult with the LA is not known, but it is not anticipated that the department would incur significant costs.

ECONOMIC IMPACT

Revenue Estimate

This bill is estimated to impact B&CT revenue as shown in the following table.

Fiscal Year Cash Flow Impact Effective For Transactions After 12/31/01 $ in Millions			
Assumption	2001-02	2002-03	2003-04
$200 Million In Lease/Leaseback Transactions Annually	Negligible	Negligible	Minor

Negligible - less than $250,000 per year
Minor – less than $500,000 per year

The estimate assumes $200 million dollars in yearly lease/leaseback transactions as provided for in this bill. It should be noted that the overall impact of these agreements must result in a tax positive transaction for federal purposes. The positive tax impact is created in the last year of the lease, generally over 25 years from the inception of the lease.

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

Revenue Discussion

The revenue impact for this bill will be determined by the value of vehicles sold or leased under a leaseback agreement as provided for under this bill, the timing and amount of lease payments and associated income tax deductions, and the California tax status of the corporate investors.

This estimate was developed in the following steps. First, it was assumed that the bill would become operative on January 1, 2002. Second, the amount of yearly transactions associated with this bill was projected to be $200 million. This amount is based on the projected purchases of qualified vehicles in California and the projected qualified vehicles currently owned by California public transit systems that have been in use for more than 90 days and eligible for a lease/leaseback transaction under this bill. Third, based on available information from industry experts, a ratio of 4 percent of the entire transaction amount was used as the expected yearly loss for California income tax purposes. An average marginal tax rate of 2 percent was applied to derive the projected yearly income tax revenue loss. The estimated average marginal tax rate takes into consideration an average apportionment factor of 20 percent for the types of financial institutions involved in these types of transactions and an average marginal tax rate of 10.84 percent.

Information from California Transit Association, Federal Transit Administration, BOE, San Francisco Public Transportation Department, as well as other outside and in-house resources, was used in the development of this revenue estimate.

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